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IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 448.

PETROLEUM EXPLORATION, INC.,
Petitioner,

vs.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

BRIEF FOR PETITIONER.

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OPINION BELOW.

The opinion of the Board of Tax Appeals appears in the Record at pages 30 to 33, and is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals appears in the Record at pages 42 to 51, and is reported in 61 F. (2d) 273.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered October 8, 1932. The petition for certiorari was

filed October 12, 1932, and granted November 14, 1932. Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether, under the Revenue Act of 1926, the capitalized cost of drilling oil wells and of hauling and placing equipment in the wells is recoverable through depreciation as contended by the petitioner or through depletion as contended by the Commissioner of Internal Revenue.

The Board of Tax Appeals held that the entire cost of drilling the wells and of hauling and placing equipment was recoverable through depreciation. The Circuit Court of Appeals held that the cost of hauling and placing equipment was recoverable through depreciation, but that the cost of drilling the wells was recoverable through depletion.

STATUTE AND REGULATIONS INVOLVED.

Revenue Act of 1926:

> "SEC. 234. (*a*) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * * * * * *
>
> "(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;
>
> "(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case

of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

"SEC. 204(*c*)(2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Treasury Regulations 69 provide:

"ART. 221. Depletion in the Case of Oil and Gas Wells.—Under Section 204(*c*)(2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, 'the property,' as the term is used in section 204(*c*)(2) and this article, refers to the separate tracts or leases of the taxpayer."

"ART. 223. Charges to Capital and to Expense in the Case of Oil and Gas Wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *"

"ART. 225. Depreciation of Improvements in the Case of Oil and Gas Wells.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161-170.)"

STATEMENT OF THE CASE.

This case involves deficiencies in income tax for the years 1925, 1926 and 1927 in the amounts of $700.81, $996.09 and $1,047.23, respectively. Deficiences in larger amounts asserted in the "notices of deficiency" (R. 9, 23) are due to other adjustments to income which are not contested in this action.

Two appeals were filed with the Board of Tax Appeals, Docket No. 43480 involving the years 1925 and 1926 and Docket No. 49339 involving 1927. The actions were consolidated and heard and disposed of on one record and by one opinion.

The facts, which are fully stated at pages 30 to 32 of the Record, are briefly as follows:

Petitioner is a Maine corporation with its principal office at Sistersville, West Virginia (R. 30).

On December 31, 1924, its undepreciated investment in equipment in oil wells amounted to $475,975.02.

During 1925, 1926 and 1927 the petitioner capitalized on its books of account the total cost of new productive oil wells drilled, such charges representing amounts paid for equipment put into the wells, amounts paid to drilling contractors for drilling the wells, amounts paid for freight and haulage of the equipment, and amounts paid for labor in installing the equipment in the wells, as follows:

Year	Cost of equipment	Cost of drilling wells, hauling and placing equipment	Total cost of completed producing wells
1925	$121,303.03	$49,640.17	$170,943.20
1926	15,882.88	52,994.14	68,887.02
1927	56,626.31	2,659.26	59,285.57

The productive life of all producing wells, the total cost of which was capitalized as shown above, is more than one year.

Depreciation has been claimed by the petitioner and allowed by the Commissioner at a unit production rate based on the lengths of life of the oil deposits.

The petitioner, in making its computation of depreciation, added the total cost of completed wells, including equipment, drilling, hauling and placing the equipment, to its depreciation schedules, no part of the cost of the wells being added to the cost depletion schedules.

The Commissioner in making his computation of depreciation has added to his depreciation schedules the cost of the equipment added each year as shown in the above table, but has not added the cost of drilling wells, hauling and placing the equipment.

Instead, the cost of drilling wells, hauling and placing equipment, as shown in the above table, has been added to the cost depletion schedules by the Commissioner; but de-

pletion has been allowed on a statutory percentage basis (27½ per cent of gross income, not to exceed 50 per cent of net income) and is not based on cost.

The Board of Tax Appeals approved the Petitioner's method and redetermined the amount of the deficiencies accordingly, on the authority of its earlier decision in *A. T. Jergins Trust*, 22 B. T. A. 551.

The Circuit Court of Appeals (R. 42) decided that the freight and haulage of the equipment and the labor for installing it was returnable through depreciation but that the cost of drilling the wells was returnable through depletion. In accordance with the opinion the case was remanded to the Board of Tax Appeals for further proceedings in accordance therewith.

SUMMARY OF ARGUMENT.

In the administration of the earlier taxing acts the Commissioner of Internal Revenue by regulation gave the option of charging drilling costs to expense or of capitalizing and returning them through depletion. The physical property in the wells was returnable through depreciation. The Board of Tax Appeals held (*Old Farmers Oil Co.*, 12 B. T. A. 203) that the option given by the regulations is invalid as the Commissioner has no power to hold that a purely capital item is a business expense. The Board's ruling expresses a fundamental rule of tax law and of accounting. It results in records which clearly reflect income as required by the taxing acts.

The Circuit Court of Appeals, however, has held that as the taxpayer made the election under the regulations it is bound by the requirement of the regulations that the costs be returned through depletion.

The regulation was of no financial importance until the 1926 Act when the allowance for depletion was fixed at a flat 27½ per cent rate. As a consequence the taxpayer who expenses drilling costs deducts them in the year in-

curred and in addition gets the 27½ per cent depletion deduction. The taxpayer who capitalizes the expenses is allowed by the regulations only the 27½ per cent depletion deduction. The point was litigated as soon as it could be brought to the Board of Tax Appeals which has held in several cases, beginning with *A. T. Jergins Trust,* 22 B. T. A. 551, that the entire costs here involved are returnable through depreciation.

A completed oil well is a physical thing which requires the use of a vast and varied amount of material and labor, much of which has no salvage value.

The Commissioner has always followed established accounting practice by including in the cost of buildings not only the material therein but the cost of the labor of erection. Likewise machinery and other assets are capitalized at the total cost of acquisition, transporting and erecting. There is no reason why a different rule should be applied to oil wells as all the money is expended to construct a completed well.

It is true that the drill hole becomes valueless with the exhaustion of the mineral, but so do the foundations for the machinery, the "cellar," etc. Often the casing cannot be "pulled" and salvaged.

It is impossible to segregate the drilling costs from the cost of installing the casing.

The taxing acts contain a general proviso permitting the deduction of "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." In addition the statute has a special provision "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion, and *for depreciation of improvements.*"

If a word has a judicially settled meaning it must be presumed that it was used in that sense by Congress. "Improvements" as used in mining statutes means an ar-

tificial change of the physical condition of the earth on or near a mining claim as to evidence a design to discover mineral therein or to facilitate its extraction. The act, therefore, specifically provides for the depreciation of an oil well. The legislative history indicates this was the intent of Congress.

The meaning of the words "depreciation" and "depletion" was settled by *United States v. Ludey*, 274 U. S. 295, and depletion applies only to the mineral.

ARGUMENT.

Cost of Drilling Oil Wells is Capital Expenditure and Not Expense.

During the many years that depletion of oil and gas wells has been allowed the Commissioner of Internal Revenue by regulation has held that the cost of wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines and development of the property, could, at the option of the taxpayer, be deducted as expense in the year in which incurred or capitalized. See Art. 170, Regulations 33 (1917 Act); Art. 223 of Regulations 45, 62, 65, 69 (1918, 1921, 1924 and 1926 Acts); and Art. 243, Regulations 74 (1928 Act). If the said costs were capitalized the Commissioner required that they be returned through depletion. The cost of physical property having a salvage value was returnable through depreciation.

While this case is not concerned with the situation where the costs were deducted as expense it is interesting to note that the Board of Tax Appeals has held the regulation invalid:

> "Before discussing this regulation (Art. 223, Reg. 45), it is expedient to point out that what is properly a capital investment is not and cannot be an ordinary and necessary expense and that the reverse is

> equally true. The Revenue Act of 1918 conferred no authority on the Commissioner to arbitrarily determine by regulation or otherwise that a purely capital item was a business expense. Compare *Union Metal Manufacturing Co.*, 1 B. T. A. 395; *Union Collieries Co.*, 3 B. T. A. 540; *Boyne City Lumber Co.*, 7 B. T. A. 36. Much less could he authorize a taxpayer to elect whether he will deduct from gross income an expenditure made for a purely capital purpose as an ordinary and necessary expense. * * *" (*Old Farmers Oil Co.*, 12 B. T. A. 203, 217.)

The Commissioner acquiesced in the Old Farmers Oil Co. case, C. B. VII-2, p. 30.

The foregoing quotation expresses a fundamental rule of tax law. Likewise it expresses a fundamental rule of accounting. If this taxpayer had expensed and not capitalized the amounts here involved its books would not have reflected actual facts. Income would be distorted and assets with a life of approximately fifteen years would not be shown as assets.

The taxing acts have always required that taxpayers' records be so kept as to clearly reflect income. The regulation results in a failure to clearly reflect income and is beyond the Commissioner's power.

The Circuit Court held, in the case at bar, that because this taxpayer has sought to keep its books in such a manner that they reflect the true facts it is to be placed at a disadvantage as compared with a taxpayer who charges capital items to expense. The Court states (R. 47):

> "Here the taxpayer was given the option under the provisions of Article 223 of Regulations 69 to either charge the expenditures in question to development expense or charge them to capital account *returnable through depletion.* (Italics ours.) This option was exercised by the taxpayer by charging the expenditures to capital account, and by so acting the taxpayer must have done so with the full knowledge that such sums so charged must come back through depletion and not depreciation. This is the plain provision of the Regulation."

The option provided in Article 223 had no financial effect on oil operators who capitalized drilling costs until the enactment of the Revenue Act of 1926. In prior revenue acts both depreciation and depletion were returnable on a "unit of production" basis so it made no difference whether the drilling costs were added to the depreciable base or depletable base. By either method the taxpayer recovered his cost. Due to the uncertainty of administration of the "discovery" sections of the law, Congress in the 1926 Act (which applied to 1925 and subsequent years) provided for an arbitrary depletion deduction of 27½ per cent of the gross income from oils and gas wells. As a consequence the taxpayer who expenses drilling costs gets that deduction in the year the expenses are incurred and in addition gets the 27½ per cent depletion deduction. On the other hand, the taxpayer who keeps books that reflect true facts secures, under the Commissioner's ruling, only the 27½ per cent deduction and can never recover the drilling costs.

The interpretation of the Commissioner on the point involved was litigated as soon as it was possible to reach the Board of Tax Appeals. The first decision is *A. T. Jergins Trust*, 22 B. T. A. 551, wherein it is stated (p. 562):

> "The final contention of petitioner is that respondent erred in adding its drilling development expenses to the amounts recoverable through depletion. Petitioner has waived its contention that these costs are proper subjects for annual deductions and apparently concedes that they should be capitalized. We believe that his is the proper solution of the problem. Cf. *Consolidated Mutual Oil Co.*, 2 B. T. A. 1067, *Old Farmers' Oil Co.*, 12 B. T. A. 293. Both parties agree that these capital expenditures are returnable to petitioner during the life of its lease and they differ only as to the character of the deduction. Respondent has allowed it as depletion, while petitioner claims it as depreciation. Respondent has added these expenditures to amounts recoverable through depletion and has thus determined a larger depletion unit. Ordinarily, where

there is no difference as to the rate, it would become immaterial whether the capital cost was recovered as depreciation or as depletion. But section 234 (a) (8) of the Revenue Act of 1924 as restricted by section 204 (c) of the same act places certain limitations on the deduction for depletion while the deduction for depreciation is subject to no such restrictions. In the present case the restriction operates to deny to petitioner the full amount of the deduction for depletion to which it would otherwise be entitled. Under these conditions it becomes necessary to discuss the character of the deduction. Section 234 (a) (9) of the Revenue Act of 1921 and section 234 (a) (8) of the Revenue Act of 1924 permit the deduction in cases such as this of 'a reasonable allowance for depletion and for depreciation of improvements * * *.' As we understand the stipulation, the amounts in controversy were expended in drilling wells and in operations preparatory and relating to such drilling, all of which would constitute a part of the cost of the structure recoverable through depreciation. On the other hand, the concept of the term 'depletion' is the exhaustion of the mineral content of a mine or an oil well. *United States v. Ludey*, 274 U. S. 295. The precise wording of the statute indicates clearly that Congress had in mind the distinction between the exhaustion of the natural resources and the recovery of the capital invested in the improvements necessary to work the property. It can not be seriously contended that the exhaustion of petitioner's investment in preparing for and in drilling its wells constitutes any part of the exhaustion of its oil reserves.

"The Commissioner relies upon article 223 of Regulations 62 which provides:

> 'Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to the capital account returnable through depletion. *If*

in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * *'
(Italics supplied.)

"If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated. It seems to us, however, that the regulation has not been properly applied in this case. The construction used in computing the deficiency was that tangible assets which go upon the property, such as lumber, cement, casing, tubing, etc., are all charges that 'are represented by physical property while other costs were not.' The cost of labor for erecting the derrick or drilling the well, the fuel used in such operation, the cost of hauling such materials are all 'represented by physical property.' The Commissioner in his brief recognizes that such is the case and now urges that we sustain his action upon the ground that the stipulated facts are insufficient to show what part of the amount disallowed were represented by physical property. The stipulation shows that the Commissioner has allowed as the cost of improvements (the word used in the statute) only the amounts expended for physical equipment and has refused to treat as cost of improvements amounts expended for wages, fuel, repairs and hauling 'in connection with development and drilling.' This terminology excludes the idea that any part of such amount was expended in discovery or exploration work or in operating the leased property. Amounts expended in development and drilling operations convey to us the impression of expenditures for improvement of the property upon which the statute permits the taxpayer to deduct depreciation. The adjustment of taxable income will be accomplished by allowing as depreciation the amounts previously treated as depletion allowances upon these expenditures."

The Jergins decision was followed by the Board in the cause at bar; *Ziegler, et al.*, 23 B. T. A. 1091; *P-M-K. Petroleum Co.*, 24 B. T. A. 360; *Twin Bell Oil Syndicate*, 26 B. T. A. 172; and by the Court of Claims in *Dakota-Montana Oil Co. v. United States*, 59 F. (2d) 853, now pending before this Court (No. 434). The Jergins case was disposed of by the Circuit Court of Appeals for the Ninth Circuit on other grounds and is now pending before this Court on petition for a writ of certiorari (No. 541).

It should be realized that a completed oil well is a physical thing which can be seen and touched. It performs a useful function. It consists of an aggregation of physical things such as pipes, casings, valves, pumps, tanks, and various other articles of metal and lumber. In accomplishing the completion of the oil well heavy machinery must be transported to the site, a boiler and engine must be set up, and a derrick of wood or steel must be erected for handling the tools and casing. This must be equipped with drilling machinery. There must be surface excavation, the building of foundations for machinery, and other similar work before drilling begins. Where high pressures are expected there is constructed an elaborate concrete "cellar" through which the drilling is carried on. The cellar foundations and many other component parts of the well have no salvage value and cannot be moved. Large supplies of fuel and water must be provided and the transportation of fuel, water, other supplies, casings and equipment may be one of the important items of expenditure. Both skilled and unskilled labor are required for the actual drilling operation. The labor is expended partly in making the hole and partly in the installation of the casing and other equipment. When the hole has reached a depth of a few hundred feet at large diameter it is lined with steel casing which is usually cemented into place at the bottom. Large quantities of cement are used, especially if water or some other difficult condition is encountered. Drilling

then proceeds through the casing several hundred feet deeper, when a second casing of smaller diameter is placed inside the first reaching from the surface to the bottom of the hole, and drilling then goes on. Often a well has several concentric casings of which only the innermost and smallest reaches to the ultimate depth. If the well is a producer, such as those here involved, there is a further use of labor in making it ready to flow or to be pumped, including the construction of flow lines and flow tanks, the installation of pumps, etc.

Without the labor, the freight, and all such things for which the costs above enumerated were incurred, it would be impossible to produce a completed oil well which is the ultimate physical object here involved.

The Commissioner has permitted the physical property with which the wells were equipped to be capitalized and returned through depreciation. He has insisted, however, that the many other costs of drilling wells, hauling and placing equipment, etc., as enumerated above, must be considered as returnable through depletion. The Circuit Court of Appeals held that the cost of putting down the drill hole is returnable through depletion, but the other costs are returnable through depreciation.

In the administration of the taxing acts the Commissioner has always followed the established accounting practice that the cost of any asset includes the cost of transporting and erecting the material. Thus a building is capitalized at the cost of the completed structure, not merely the cost of the material entering into the building. It is well known that the labor of constructing a building usually exceeds the cost of the material therein. Likewise it has always been the practice to capitalize machinery and other assets at the total cost of acquisition, transporting and erecting. To do otherwise would not reflect true facts. There is no possible reason why a different rule should be applied to an oil well. All of the money is expended to

construct the completed well. This applies to the drill hole as well as the other parts of the well. The drill hole is put down for the sole purpose of installing the casing and machinery and bears the same relation to the completed well as does the excavation and foundation to a building. It is true that the drill hole becomes valueless with the exhaustion of the mineral, but so do the excavations and foundations for the machinery, the "cellar", etc. In fact, the casing often cannot be salvaged because it is so securely cemented in the well that it cannot be "pulled." In other words, the many items that go to make up an oil well cannot be segregated and there is no reason why an attempt should be made to segregate some of them for purposes of depreciation. The realities of the situation are such that the labor of making the hole and of installing the casing, is so interrelated that it cannot be segregated as the Circuit Court of Appeals suggests it should be.

Statute Specifically Provides for Depreciation of Improvements.

The petitioner contends that the situation here presented is specifically covered by the statute and that the items here involved must be returned through depreciation.

The various taxing acts have provided that all business concerns are entitled to deduct from income "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." The foregoing is a general provision. In construing the earlier taxing acts this Court held (*Von Baumbach v. Sargent Land Co.*, 242 U. S. 503) that "depreciation" did not mean "depletion." In the 1918 Act there was inserted the language which is in the act here involved as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion, and *for depreciation of improvements* * * *"

The allowance for depreciation of improvements is something in addition to the usual "reasonable allowance for the exhaustion, wear and tear of property" and applies only to mines, oil and gas wells, other natural deposits and timber.

It is established that if a word has a judicially settled meaning it must be presumed it was used in that sense by Congress. *U. S. v. Merriam*, 263 U. S. 179, 187; *Kepner v. U. S.*, 195 U. S. 100, 124; *The Abbotsford*, 98 U. S. 440, 444.

It must follow, therefore, that when Congress inserted the special proviso with reference to the deduction for depreciation on improvements it used the word "improvement" as it is used in the mining industry. In the "Glossary of Mining and Mineral Industry," published by the United States Bureau of Mines, it is stated:

> "*Improvement.* As used in the mining statutes, is an artificial change of the physical condition of the earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick v. Klauser*, 32 Oregon, p. 116). See *also* Labor and Improvement." (p. 357.)
>
> "*Labor and Improvements.* Labor performed or improvements made for development in such manner as to facilitate the extraction of the metals, though such labor and improvements may not be on the particular location itself (Smelting Co. v. Kemp, 104 United States, p. 651 (636); Jackson v. Robey, 109 United States, p. 444; Justice Min. Co. v. Barclay, 82 Fed. Rept., p. 560; Anvil Hydraulic and Drainage Co. v. Code, 182 Fed. Rept., p. 206)." (p. 383.)

Reference to the decisions of this Court cited in the Glossary shows that the word "improvement" as above defined is the definition given by this court.

In fact in the common use of the word even a water well is understood to be an improvement. It often happens that

a good water well is one of the most important of all the "improvements" contributing to the value of a farm.

That Congress clearly had in mind that the expenditures here involved should be recoverable through depreciation rather than through depletion is clearly shown by the legislative history of the provision. Prior to the Revenue Act of 1918 there was no provision in the statute similar to the provision here involved. In listing the deductions allowed from gross income in the Revenue Act of 1918, however, Congress inserted the identical language which is still in the statute, namely, adding after "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion" the following "and for depreciation of improvements * * *." In explaining this addition to the Revenue Act of 1918 the Ways and Means Committee of the House of Representatives in reporting the bill stated (p. 10):

> "The depletion provision of existing law does not grant an allowance for cost of development. In the case of mines, oil and gas wells, such an allowance seems only equitable and fair and the bill provides that a reasonable allowance in such cases be allowed for depreciation of improvements. * * *"

In view of the history of the provision and the judicially settled meaning of the word "improvements" it would seem that the only possible construction to be placed on the provision is that this taxpayer is entitled to depreciation on the entire "improvements" which include the drilling costs as well as the actual equipment itself.

Depletion and Depreciation Have Entirely Different Meanings. Depreciation is the Only Deduction Applicable in This Case.

The word "depreciation" comes from the Latin word "depretaire" meaning to lessen in price or value. The

word "depletion" comes from the Latin word "deplere" meaning to empty or exhaust.

That the words have separate and distinct meanings is settled by *United States v. Ludey*, 274 U. S. 295, in which the court explained the difference between the two words. At page 300 the court said:

> "* * * The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charge is the measure of the cost of the part which has been sold. * * *."

On page 302 the Court said:

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed. The fact that the reserve is hidden from sight presents difficulties in making an estimate of the amount of the deposits. The actual quantity can rarely be measured. It must be approximated. And because the quantity originally in the reserve is not actually known, the percentage of the whole withdrawn

> in any year, and hence the appropriate depletion charge, is necessarily a rough estimate. But Congress concluded, in the light of experience, that it was better to act upon a rough estimate than to ignore the fact of depletion."

It seems clear that the distinction between "depletion" and "depreciation" is established and that the depletion deduction can apply only to the exhaustion of the mineral. The Commissioner, however, seeks to have the depletion deduction also cover the facilities for removing the mineral. This, it seems to us, is clearly erroneous because such facilities are the very "improvements" for which the statute provides an allowance for depreciation.

The words "oil and gas wells" when used in Section 234(a)(8) obviously refer to the natural deposit. This is apparent because Section 204(c)(2) provides that "in the case of oil and gas wells" the depletion allowance shall be 27½ per cent of the gross income. The term "depletion" is intended to apply only to the mineral itself, while the term "depreciation" is intended to apply to every other element or improvement making up the completed oil well. This is further indicated by the use of "other natural deposits and timber" after "mines, oil and gas wells" when the reasonable allowance for depletion is provided by Section 234(a)(8).

CONCLUSION.

In view of the foregoing the Board of Tax Appeals should be affirmed.

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